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SPECIAL ISSUE

THE 1986 INVESTOR'S GUIDE

FEATURING THE

FORTUNE INVESTMENT CHALLENGE

Six brokerage houses compete to create the best portfolio for you

FALL 1985 VOL. 112, NO. 10

FORTUNE

SPECIAL ISSUE: THE 1986 INVESTOR'S GUIDE

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INVESTMENT STRATEGY AND VEHICLES

HIGH-SCORING STRATEGIES WITH STOCKS

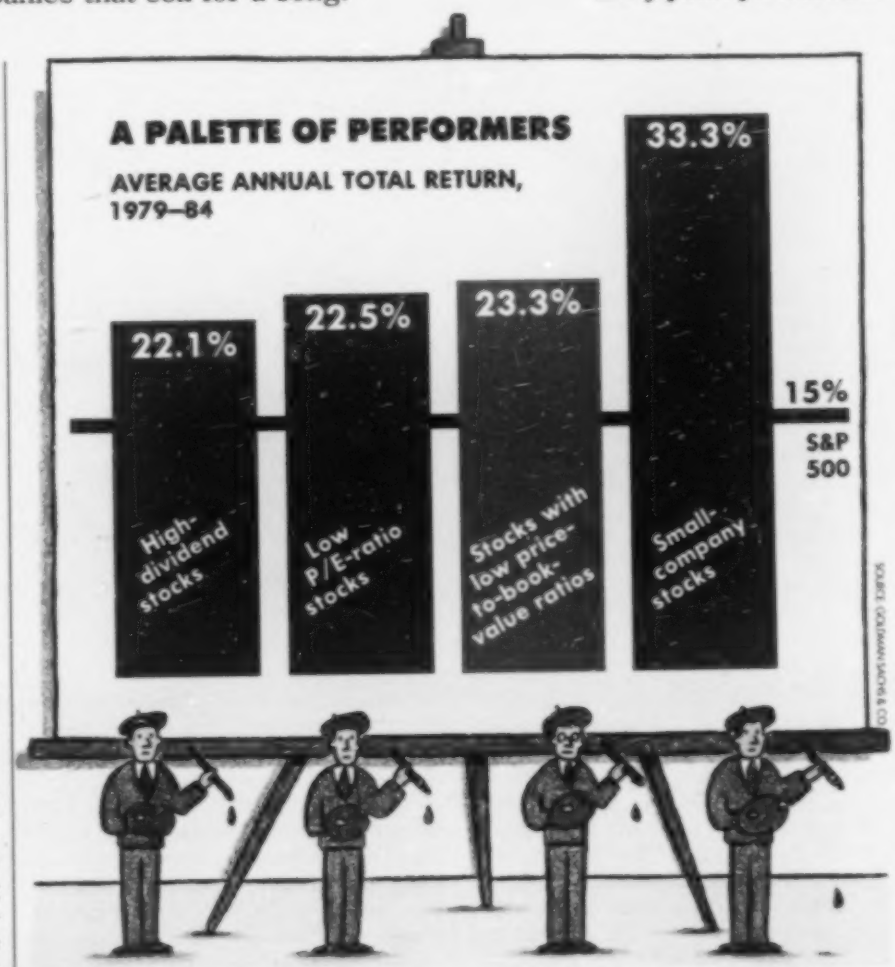
The market is tough to beat. But investors can come out ahead by shunning well-known companies with dazzling records—and stock prices—in favor of little or lackluster companies that sell for a song.

■ *by John J. Curran*

NOBODY LIKES being average, least of all investors. In a tireless quest to beat the stock market averages, Wall Street firms spend vast sums, hire legions of financial analysts to forecast company earnings, and spend countless hours poring over stock market data in the hope of divining future market movements. Individual investors vie for outsized returns too, paying hefty commissions to brokers in return for advice that could give them an edge. Yet for all that effort, the results are often disappointing. Right now the pros are on a losing streak. The average professionally managed portfolio monitored by SEI Corp., a Wayne, Pennsylvania, firm that tracks money managers' performance, beat Standard & Poor's 500-stock index in only two of the eight calendar quarters that ended in June 1985. For ten years, in fact, most professionals have trailed the market.

That comes as no surprise to proponents of the efficient-market theory. Because stock prices quickly move to take account of all publicly available information about companies, this school maintains, efforts to beat the market are doomed from the start. The only hope of doing it, this group says, lies in either trading illegally on inside information or buying especially risky stocks. If the efficient marketers are right, an investor's only recourse is to follow the lead of an increasing number of pension funds and other institutions that have thrown in the towel. They've put their money in so-called stock market index funds that follow the ups and downs of the S&P 500 like a shadow—never under-

RESEARCH ASSOCIATE *Brett Duval Fromson*



Over the six years through 1984, an investor could have bested Standard & Poor's 500-stock index by picking the 100 stocks with the lowest price-earnings multiples, the lowest prices in relation to book value per share, the highest dividend yields, and the smallest market capitalization.

INVESTMENT STRATEGY AND VEHICLES

performing it, but never outperforming it either.

Yet the individual investor's prospects may not be so bleak after all. As the chart on page 25 suggests, investors who concentrated in recent years on certain types of stocks—generally low-priced stocks—have run circles around the S&P 500. Defenders of the efficient-market theory grudgingly attribute these successes to "market anomalies," or unexplained irregularities, that may be a passing thing. But if the anomalies persist, as many savvy folks on Wall Street believe they will, investors can exploit them for above-average gains.

The winning investment strategies seek to profit from a widely held theory: most of the time, a large number of stocks sell for less, sometimes substantially less, than they are worth. Determining precisely what a stock is worth, which Wall Streeters call its intrinsic value, is impossible. But many investment firms try to get a rough idea by using what's known as the dividend discount model. Simply put, the model determines the present value of a company's projected stream of future dividends. Wall Street firms all have different proprietary versions of the dividend discount model. With some the findings are expressed as an anticipated total return on each stock—dividends plus price appreciation—in the near future. Other models estimate each stock's intrinsic value so it can be compared with the current market price.

To get a handle on intrinsic value, security analysts first forecast long-term earnings growth for each company and then predict its dividend-paying capability. To discount future dividends to their present value, they use an interest rate based on the yield on long-term Treasury bonds, currently about 10%. Thus discounted, a $1 dividend to be paid in the year 2000 would have a present value of about 25 cents. As interest rates change, the present value is updated.

No one knows, of course, what a company's dividend will be 15 years hence. But by using long-term growth-rate projections and estimating a company's future financing needs, analysts try to guess how much money will be available for dividends in years to come. Even stocks that currently pay no dividends at all are valued this way; it's assumed that at some point successful companies will begin generating excess cash that they can disburse to shareholders.

The dividend discount model is cold and calculating. Investors are not. Though a company's intrinsic value may not change much from month to month, stock prices nonetheless bounce all over the place. That's because investors do not always buy or sell stocks on the basis of intrinsic value. They often buy because they are impressed by a company's management or an exciting new line of products. They often sell because they fear an oncoming recession or some other event that could damage near-term earnings. Hence, market prices can swing far above or far below what stocks are actually worth according to the dividend discount model. Therein lies opportunity.

Winning strategies profit from a widely held theory: a large number of stocks generally sell for less, sometimes substantially less, than they are worth.

If lots of underpriced stocks truly exist, though, why aren't those savvy pros with all their formulas and fancy computer programs snapping them up? Well, some of them are. In recent months, with the stock market averages close to record highs, relatively few stocks were selling below their intrinsic value. But Morgan Stanley, on the basis of crunching stocks through the dividend discount model, saw bargains in such companies as Manufacturers Hanover, the bank holding company; Travelers Corp., the insurer; and Hospital Corp. of America. The model showed that Hospital Corp.'s stock, for example, was worth $47 a share; its recent market price was $41.

Many pros, however, are loath to recommend stocks that show up on computer screens as undervalued. Undervalued companies tend to be pariahs to the financial community—typically their earnings have temporarily collapsed or they are facing big lawsuits or flirting with bankruptcy. Says Tony Estep, head of Salomon Brothers' strategy systems group, which tracks the results of different investing approaches: "The stocks that come up looking cheap also happen to be uglier than sin. Money managers are reluctant to build a portfolio of companies like that." Yet Estep's findings indicate that over the years, unloved stocks have been among the best performers around.

Running thousands of publicly traded companies through the dividend discount model is beyond the resources of the individual investor. But by following simple strategies—none of which require an earnings forecast—it's possible to come up with good results. Steven Einhorn, co-chairman of the investment policy committee at Goldman Sachs, discerns four strategies that would have been winners over the six years through 1984: concentrating on stocks that ranked in the 20% of the S&P 500 with the lowest price-earnings multiples, or the lowest market prices in relation to book value per share, or the highest dividend yields, or the smallest market capitalization (total market value of all outstanding shares).

The performance figures in the chart on page 25 are artificial in that they exclude trading commissions, which can be considerable. Moreover, the six-year period over which Einhorn tracked these investing strategies is too short to prove that they will invariably work. But each of these strategies has been studied over longer periods and in actual portfolios. The results are still superior. And while the small investor cannot afford to hold portfolios containing 100 stocks or more, the results argue strongly for concentrating investments in these four areas.

That simple strategies should work so well in the complicated world of stocks is no coincidence. Like the dividend discount model, which compares a stock's current price with its intrinsic value, the first three of these strategies focus directly on ratios or percentages that involve price. Price isn't the same as value, but it helps investors narrow the search for bargains. Sanford C. Bernstein & Co., a New York-based invest-

INVESTMENT STRATEGY AND VEHICLES

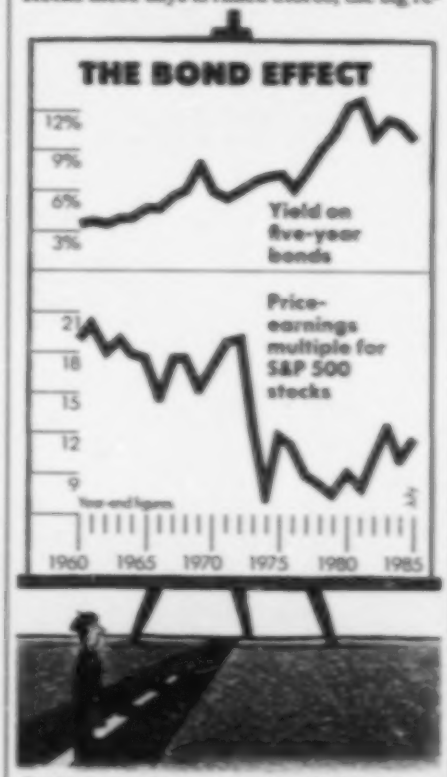
ment firm, has achieved above-average returns by adhering religiously to the dividend discount model. Says Peter Carman, chief investment officer: "Our approach to finding value is far more elaborate than any simple ratio. Yet stocks that we find to be undervalued also tend to have some common characteristics: low P/Es, low ratios of price to book value per share, and high dividend yields."

That out-of-favor companies should offer higher returns is not surprising. "It makes perfect sense," says Estep of Salomon Brothers. Over time, he says, an investor's return from owning a particular stock should roughly equal what it costs the company to raise capital. In a rational world a company with a terrific track record and excellent prospects should be able to issue stock at a high price with a lofty P/E multiple, while a lackluster company with less exciting prospects would have to issue cheaper shares with lower P/Es and price-to-book ratios and offer above-average dividend yields.

It stands to reason, Estep adds, that investors who buy expensive stock from terrific companies should not expect above-average returns. In particular, he says, investors should be leery of high-growth companies, the elite of American industry. These companies have brilliant managers and chalk up dazzling profits; institutional investors love them. But they have one major drawback. As the late Benjamin Graham, the father of value-based investing, succinctly put it: "Common stocks with good records and apparently good prospects sell at correspondingly high prices." Adds Einhorn of Goldman Sachs, "Many investors are of the opinion that you ought to buy good-quality, growth-oriented companies, and they pay a premium for that. They focus so much on growth, to the exclusion of price, that they overpay for good growth."

Because the market overvalues growth, it also excessively discounts the lack of it. Investors who specialize in underpaying for companies with sluggish growth and other problems are often described as contrarians, because they're willing to run against the herd. One of the most outspoken is David Dreman, managing director of Dreman & Embry, a New York-based money management firm, and author of *The New Contrarian Investor*. Dreman recently concluded a study of low-P/E-stock performance over the past 12 years. He divided the Value Line list of 1,700 stocks into ten groups ranked by P/E and reviewed the performance of each group through good markets and bad.

"The results are amazing," Dreman says. "In good stock markets, low-P/E stocks did better than high-P/E stocks, and in bad markets, the low-P/E stocks declined less." In fact, he adds, the lowest-P/E stocks did best of all. Among Dreman's favorite low-P/E stocks these days is Allied Stores, the big re-



Stocks are constantly competing with bonds for the investor's dollar. So when bond interest rates rise, the price-earnings multiples of stocks tend to fall. The two movements don't exactly mirror each other, however, because stock prices react to other developments, such as earnings trends.

tailing chain that owns and operates such well-known stores as Brooks Brothers and Garfinkel's, and has sold lately at a P/E multiple of seven times the company's earnings in the past four quarters. He also likes R.J. Reynolds Industries, the big tobacco producer that recently merged with Nabisco Brands, the cookie company. At recent prices, Reynolds commanded a P/E multiple of 6. Both stocks are well below the average stock market P/E multiple of 11.5.

How is it that such simple ratios as these, based on reported past earnings and reflecting no forecast of earnings, can be so pregnant with implications for future stock price performance? For one thing, some mighty important information is packed into a P/E. Consider, for example, two hypothetical companies, one with a return on shareholders' equity averaging 20%, far above the industry norm, the other a hard-luck story, averaging only a 10% return on equity. Our highly profitable company, call it Worldbeater Enterprises, is selling at a price-earnings multiple of 14. For simplicity, assume it earned $1 a share in the past four quarters and sells for $14 a share.

Fourteen times earnings may seem a bargain for a company with above-average profitability. But look again. Invert the P/E: instead of dividing price by earnings, do the reverse. What you get is not Worldbeater's return on equity, but your own personal return on equity, more properly called the earnings yield. In this example, your earnings yield works out to a not-so-rosy 7.1%. Our hard-luck company, Rustville Gear Works, may sell at a P/E of 7. But the investor's earnings yield is 14.3%.

To be sure, focusing narrowly on P/Es has pitfalls. The quick and simple comparison of multiples ignores each company's growth rate, which bears importantly on value. Moreover, on rare occasions growth stocks with high P/Es can perform better than low-growth, low-P/E companies. When interest rates fall, all P/Es tend to rise, and when interest rates rise, all P/Es tend to fall (see the chart at left). That's because sophisticated investors constantly compare the earnings yield they can get from stocks with the return they can get on bonds. The inverse relationship between P/Es and interest rates is magnified in the case of high-P/E stocks. These stocks tend to be of fast-growing companies that need barrels of cash to finance growth and aren't likely to have much available for dividends in the near future. Thus the present value of the company's far-off dividends is highly sensitive to even the slightest change in interest rates. A sharp drop in bond rates, as occurred in the last half of 1984, can send the value of high-P/E stocks soaring.

Investors who focus only on low-P/E stocks will miss yet another opportunity. In the trough of a recession, so-called cyclical companies, whose earnings rise and fall with the economy, show extremely high P/E ratios simply because their earnings are depressed. A simple search for low-P/E stocks won't catch them. Still, says Carman of Sanford C. Bernstein, a low-P/E approach to stocks should enable investors to ferret out most of the undervalued stocks.

Investors who zoom in on stocks selling at a low percentage of book value per share also stand to book big profits. Book value per share is another name for the net worth of a

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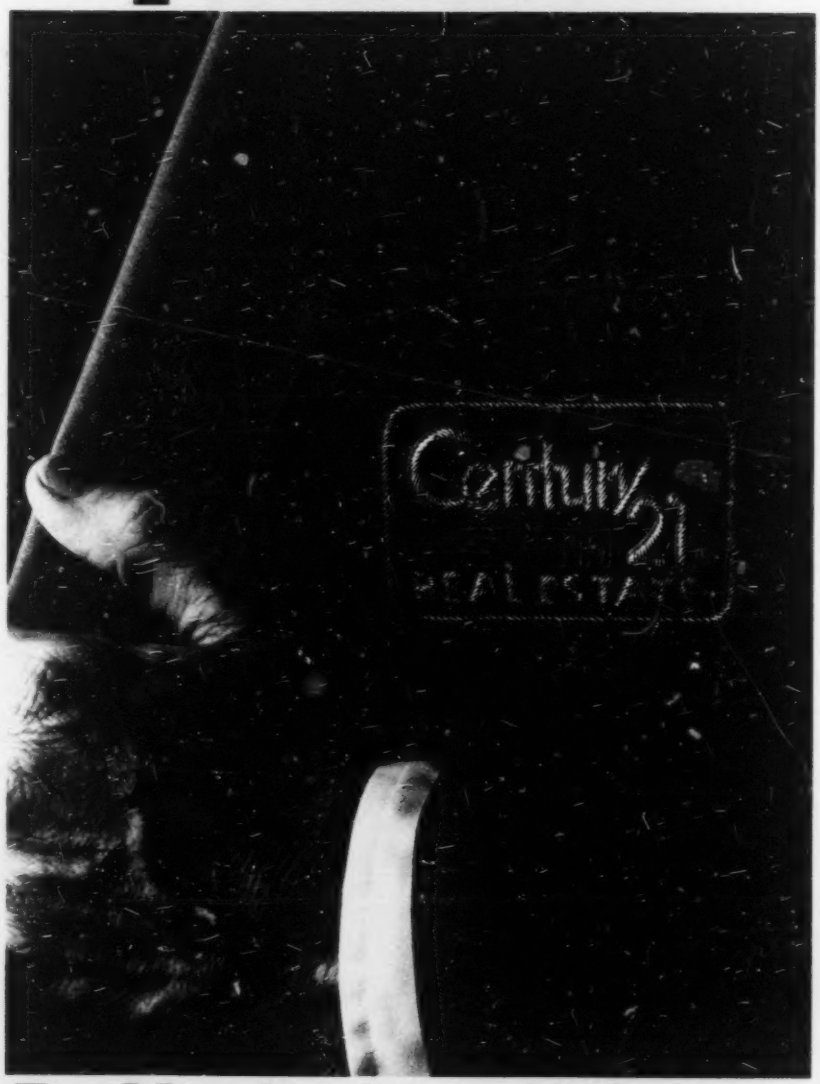

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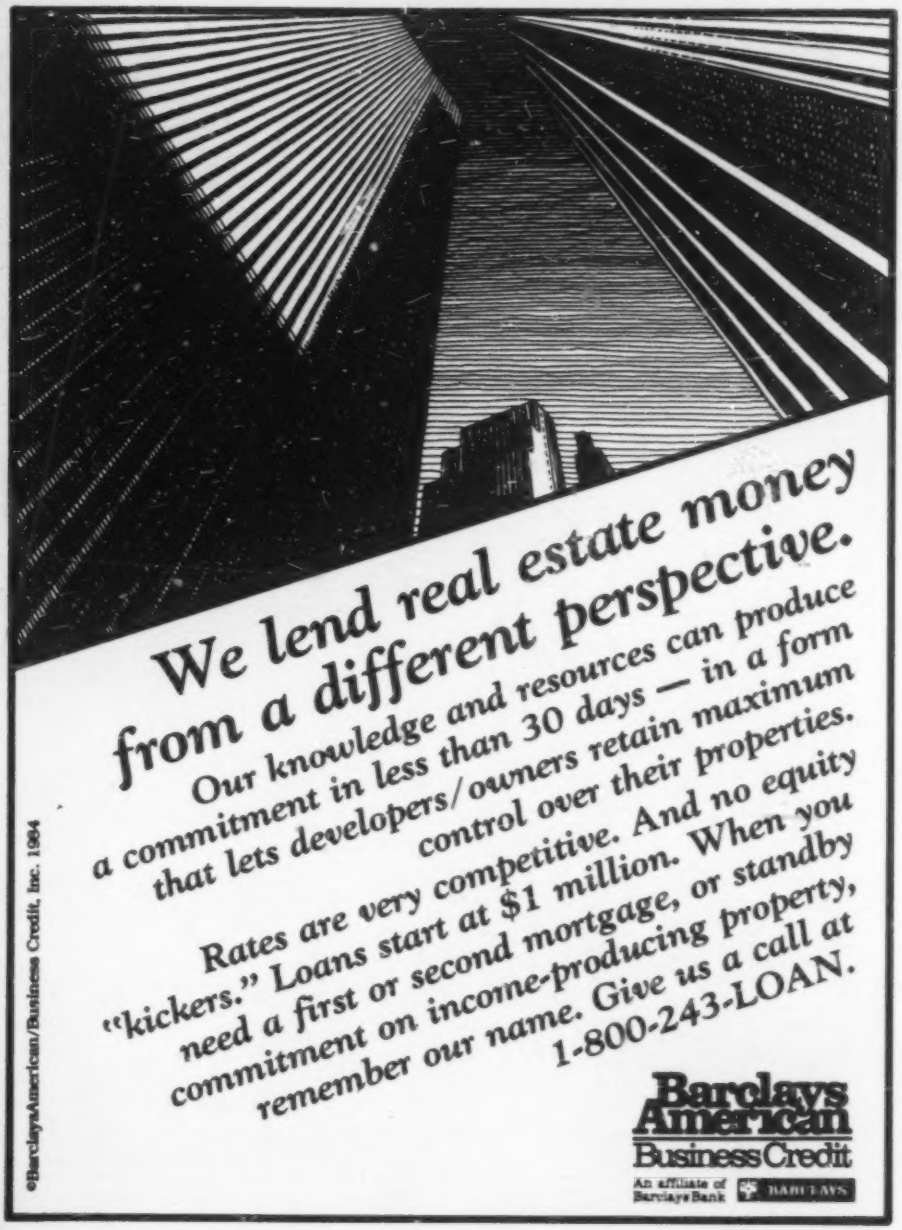
INVESTMENT STRATEGY AND VEHICLES

company—what's left after all the liabilities are subtracted—divided by the number of shares of stock. It's no coincidence that low-P/E investing and low price-to-book-value investing should both produce good results. The two strategies are similar. Assuming no change in a company's profitability, a drop in the price-to-book-value ratio will mean a drop in the P/E as well. Of course, profitability does change and P/Es and price-to-book-value ratios don't always move in tandem. So it pays to look at both when searching out undervalued stocks.

If low ratios are desirable, high ratios are to be avoided like an infectious disease. Estep of Salomon Brothers says the normal range of price-to-book-value ratios for S&P 500 companies is between 0.8 to 1 and 4 to 1. Over time, he says, most companies gravitate toward the middle of that range. Hewlett-Packard, for example, sold at a lofty five times book value per share in 1970. "You could have bought it almost anytime in the past 15 years and not made a return greater than you'd have had from a government bond," Estep says. "That's not because Hewlett-Packard's earnings didn't grow—they grew like a shot. Rather, you didn't make money because over that time the stock was going through a constant downward valuation in its price-to-book ratio." Lately Hewlett-Packard has sold at 2.4 times book value per share.

On the other hand, investors who buy stocks selling at low price-to-book-value ratios can bask in the sunny prospect that, barring catastrophe, their stocks should slowly move upward toward the average. As an example, Estep points to the stocks of natural-gas pipeline companies that sold at deep discounts to book value in the late Seventies, but now sell at a premium. In 1978 the stock of Coastal Corp., which operates oil refineries as well as natural-gas pipelines, sold at about 50% of book value per share. Today it sells at a lofty 179% of book value. Recently U.S. Steel and Ford Motor Co. were both selling for less than their book value per share, while the average stock on S&P's 400-stock index sold for 167% of book value.

High dividends can be another route to big investment returns. Perhaps the biggest decision a stock picker must make is how much of his winnings he wants to receive up front in dividends and how much he's willing to let ride on the future growth of the company and its stock price. John B. Neff, portfolio manager of the Windsor Fund, one of the most suc-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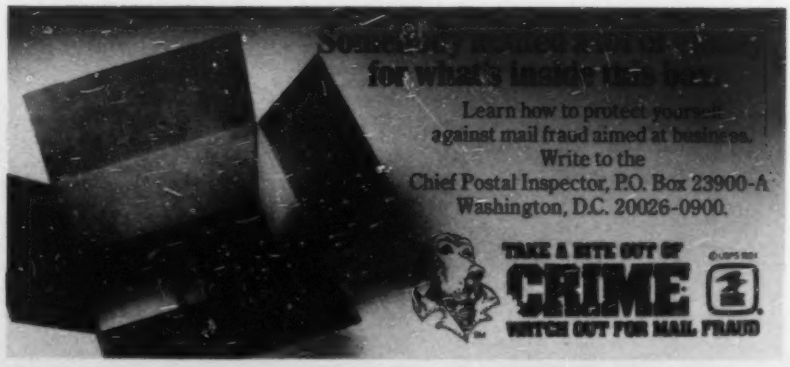
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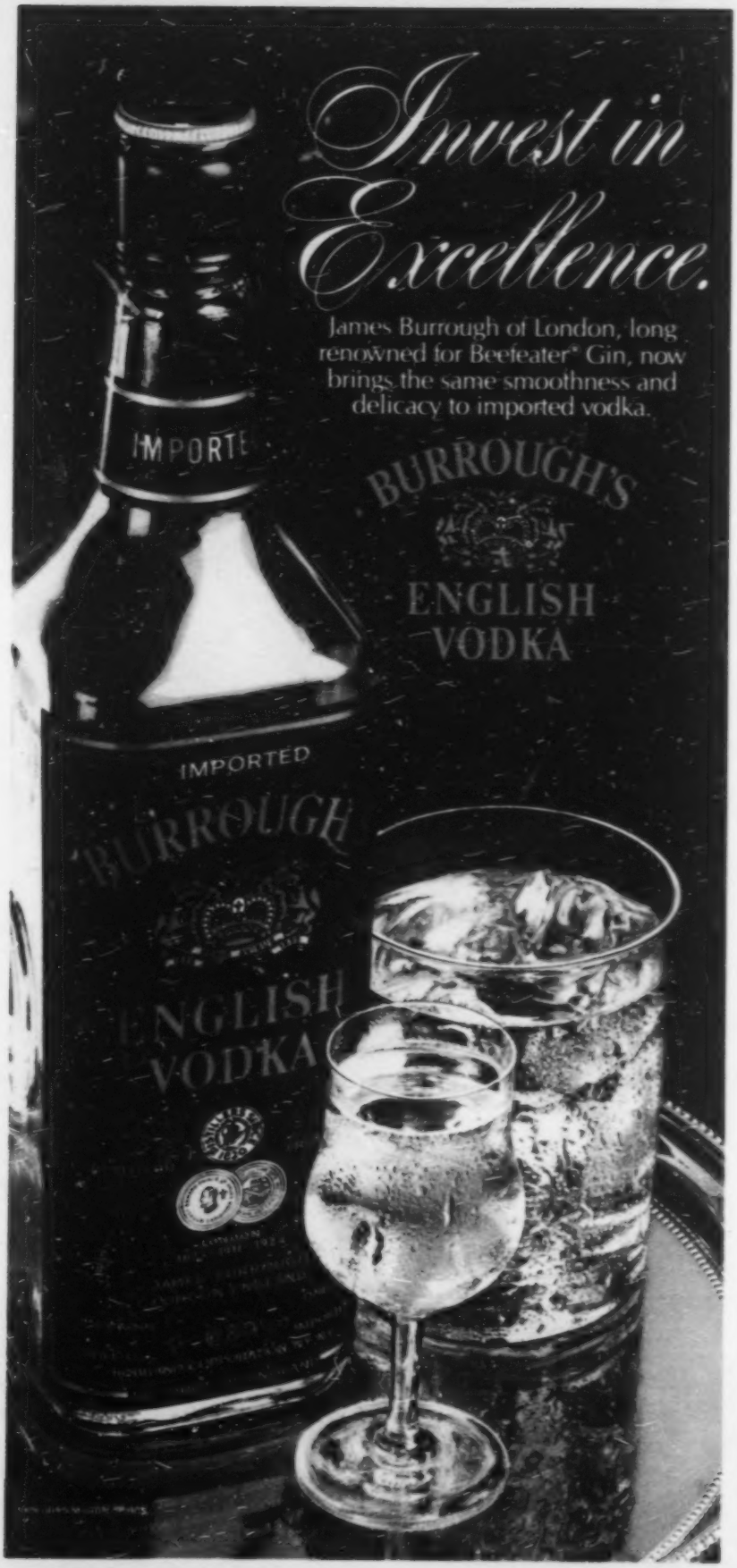
INVESTMENT STRATEGY AND VEHICLES

cessful mutual funds around, plumps for the dividends. "High growth rates can be assaulted by all sorts of challenges, from new competitors to changing market conditions," Neff explains. "Growth rates can be instantaneously revised. But an awful lot has to go wrong before the dividend suffers." Because growth rates are so vulnerable, Neff steadfastly avoids companies with projected growth of over 20% a year. "The mortality rate of those over-20% companies is just too high," he insists.

Investors who screen the stock market for high-yield stocks are likely to end up with a portfolio of utility companies. Some utilities pay extremely high dividends, but that's because the stock has plunged on the market's worries that the dividend may be cut or eliminated because of overruns on nuclear construction projects. Two of the highest-paying electric companies free of such headaches are Houston Industries, with a dividend yield of 9.9%, and Commonwealth Edison, yielding an even higher-voltage 10.1%. Both yields dwarf the 4.5% average for companies on the S&P 500. To avoid concentrating assets in one industry, dividend hunters would do well to scan each sector of the S&P 500 for the highest-yielding stocks and assemble a diversified portfolio.

By far the most successful of the four investment strategies in recent years has been the one that virtually ignored the price of a stock. By building a portfolio of stocks with small market capitalization, investors could have achieved some of the biggest gains of all over the past six years. A longer-term study by Rolf Banz, now at the European Institute of Business Administration in Fontainebleau, France, looked at stocks with market capitalizations under $50 million, going all the way back to 1926. Banz found that small stocks have been spewing out rich returns for at least half a century.

This discovery has not escaped the pros. Dimensional Fund Advisors, a money management firm set up in 1981 to exploit the opportunities in small-capitalization stocks, has already attracted more than $2 billion. In the three years through June 1985, the firm's stock portfolio was up 123%, counting reinvested dividends, vs. a 100% rise in the S&P 500. David Booth, Dimensional Fund's chairman and chief executive, sees a similarity between the superior returns on small-capitalization stocks and the above-average returns on junk bonds issued by companies with low credit ratings. "In both cases," he says, "the



INVESTMENT STRATEGY AND VEHICLES

perceived risk of bankruptcy or default is greater than the real risk, so investors wind up getting compensated for risks that don't actually exist."

When the stock market declines, even a portfolio of undervalued stocks is likely to suffer. One way to smooth out that risk, and gain higher returns to boot, is to add a generous helping of foreign stocks to a portfolio. Foreign stocks aren't safer; in fact their prices bump around more than those of American stocks. But because they are riskier, they tend to yield a higher return. From 1970 through 1984, a U.S. investor in foreign stocks enjoyed an average total return of 9.5% a year, adjusted for currency changes, well above the 8.8% return on American stocks. Since foreign economies and stock markets tend to peak at different times than America's, these stocks have a comforting way of rising when U.S. stock prices are going down.

Barton Biggs, head of international investment strategy at Morgan Stanley, has yet another reason for looking overseas. In Biggs's view, one of the main trends of the next few years will be the further decline of the American dollar against major foreign currencies. If he's right, American investors who venture abroad now could enjoy a double scoop of profits—one from rising foreign stock prices, the other from rising currencies.

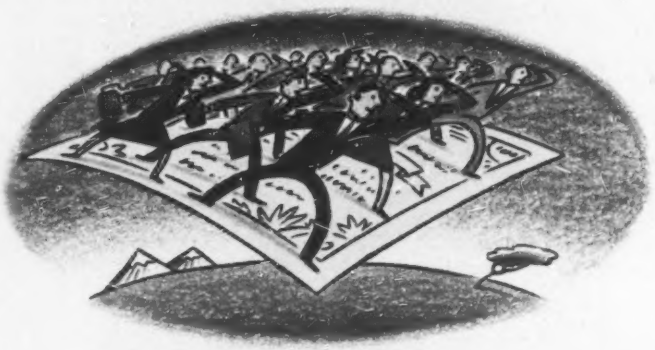
Though there are far less data on how foreign markets behave, those who watch them have discovered some of the same anomalies that offer opportunity at home. "We've found that in the Japanese and British stock markets, small stocks outperform the market just as they do in the U.S.," says Booth of Dimensional Fund Advisors. His firm is already preparing to launch two specialized funds to cash in on the phenomenon in Tokyo and London. Initially the funds will be open only to institutional investors, but if Booth's findings prove correct, it won't be long before a publicly offered mutual fund with similar objectives makes its debut.

In the end, all attempts to beat the market are a search for pockets of inefficiency. Small companies, little followed by Wall Street, constitute a fertile fishing ground for stocks whose prices are depressed by inadequate dissemination of information. Bargains also result from psychological excesses—the market's overreaction to bad news or its irrational disdain for an obscure stock. ■

INVESTMENT STRATEGY AND VEHICLES

PUTTING STOCK FUNDS TO WORK

Mutual funds provide built-in diversification and spare you a lot of decision-making. The first rule for the investor is take the long view.



IF YOU HAD picked a stock mutual fund at random a decade ago and stayed with it, you would probably have done better than if you had bought a random sample of individual stocks. In the ten years through last June, stock funds in the U.S. returned an average of 15.2% a year, vs. 12.7% for the S&P 500. Over the past five years, though, stock funds have not quite kept up with the S&P 500, and in the past year they distinctly underperformed it. With stock funds, as with individual stocks, it's best to take the long view.

According to Lipper Analytical Services, a firm that tracks the performance of mutual funds, the 479 stock funds in the U.S. have assets of almost $90 billion. They have flourished because they offer a lot of diversity for a modest initial investment—typically $500 or $1,000—and do the job of picking and monitoring stocks for you.

A RANGE OF RETURNS

TYPE OF FUND	ANNUAL RETURN 1980-85
Equity income	19.0%
Small company growth	17.3%
Capital appreciation	16.7%
S&P 500	16.6%
Growth and income	16.5%
Growth	15.7%
International	10.3%

SOURCE: LIPPER ANALYTICAL SERVICES

These Lipper terms for various categories of stock funds are widely accepted in the industry. Equity income funds differ from the others in that they can invest up to 40% of their portfolios in bonds.

The different kinds of funds can help meet different investment objectives. Aggressive investors can buy shares of what Lipper labels **capital appreciation funds** or **small company growth funds**. Both strive for maximum price gains. **Growth funds** invest in stocks of established but still expanding companies. **Growth and income funds** scour the market for stocks of growing companies that pay decent dividends. Less venturesome investors can opt for **equity income funds**, which hold both stocks and bonds and try to achieve high dividend and interest income. **International funds** buy securities traded on stock exchanges outside the U.S. Investors who want to cast their lot with particular sectors of business can choose funds that specialize, for instance, in health, natural resources, or gold stocks.

Stock funds vary considerably in size—anywhere from $100,000 to nearly $4 billion. Smaller funds tend to be riskier than larger funds because they hold proportionately more stock in smaller companies. The larger funds' greater diversity makes them less vulnerable to the market's ups and downs. But some experts think the returns from smaller funds more than make up for the extra risk. A study of 70 stock funds by Gerald Perritt, editor of the *Mutual Fund Letter* in Chicago, shows that between 1979 and 1984 those with less than $20 million in assets had a median annual return of 25.2%, while those with more than $182 million brought a return of only 13.1%.

Larger funds are less volatile but also tend to be less flexible. As investors keep pouring money into a fund, managers have two choices. They can buy more shares of stocks the fund already owns—but the more stock of any one company a fund holds, the more costly it is to get out of the stock quickly, because selling puts downward pressure on the price. The alternative is to invest in new stocks—but it may be hard for a big fund that holds stocks in scores or even hundreds of companies to find new stocks with as much promise as those it owns already.

FUND MANAGERS call this bind "overgrowth." One mutual fund star who faces this problem is Peter Lynch, portfolio manager of the enormously successful $3-billion Fidelity Magellan Fund. "We've had an 11-fold return over the past eight years," Lynch says, "but there's no way we can repeat this performance in the next eight years." Overgrowth has recently led such highly successful funds as Lindner, Windsor, Explorer, and Pennsylvania Mutual to stop accepting new accounts.

When selecting a fund, it's important not to go by recent performance alone. Anyone who bought into international or small company growth funds at the end of 1983 on the basis of their stellar returns that year got burned in 1984. You should also look at longer-term performance. Among the funds that still take new accounts, the best performers in the past five years, according to Lipper, are: capital appreciation funds, **Quest for Value Fund**, New York City; small company growth, **Sigma Venture Shares**, Wilmington, Delaware; growth, **Fidelity Magellan Fund**, Boston; growth and income, **Washington Mutual Investors Fund**, Washington, D.C.; equity income, **Fidelity Equity-Income Fund**, Boston; international, **Merrill Lynch Pacific Fund**, New York City.

You can buy shares in stock funds from the sponsors or through brokers or some large commercial banks. Some funds charge an up-front sales commission, as much as 8.5%; no-load funds don't. But all impose a built-in yearly management fee, usually around 0.6% of assets.

—Edward Boyer

INVESTMENT STRATEGY AND VEHICLES

BUYING BONDS FOR INCOME, NOT SAFETY

Once a haven for the prudent, bonds have come to be nearly as volatile as stocks. They still offer steady income, but shifts in interest rates can mean capital losses—or gains. Inflation is a menace. ■ *by Edward Boyer*

BONDS USED TO be the Gibraltar of securities, something solely for the unadventurous. They offered steady interest income, with little prospect of capital gains but little danger of capital losses—the perfect refuge for the cautious investor. No more. Bond prices rise and fall with the ebb and flow of interest rates, which now can fluctuate more in one day than they once did in a year. As a result, long-term bonds have become nearly as volatile as stocks. The basic reason for investing in bonds remains the same as ever: steady income. With interest rates on a roller coaster, however, the investor should take into account possible capital losses—or gains.

The investor should also remember that inflation can cost bondholders dearly. Most bonds carry a fixed interest rate; as inflation climbs, the real return on a bond can dwindle to zero or even become negative. Double-digit inflation in the 1970s gave bonds a bad name. Many investors found themselves stuck with bond yields that were under water. It wasn't until inflation subsided in the early 1980s that bonds came back into favor. In this recent comeback, bonds have begun to attract numerous investors who are seasoned stockholders but beginners in bonds. A road map of the terrain should be helpful.

You can buy a bond for as little as $1,000, but it takes a good many bonds to achieve a prudent diversity. If you can't afford to invest in individual bonds but still want to get a foot in the market, you can buy shares of bond mutual funds (see the following article). If you go with individual bonds, you

RESEARCH ASSOCIATE *Patricia Sellers*

A WILD RIDE FOR INVESTORS

TYPE OF BOND	BEST RETURN YEAR	WORST RETURN YEAR
Long-term high-grade corporate	+40.3% 1982	−4.0% 1979
Long-term high-grade municipal	+38.2% 1982	−15.6% 1979
Long-term Treasury	+38.1% 1982	−3.3% 1980
Medium-term Treasury	+33.3% 1982	+0.1% 1980
Long-term low-grade corporate	+32.4% 1982	+0.4% 1980
Short-term Treasury	+24.4% 1982	+5.2% 1980

SOURCE: SALOMON BROTHERS

The wide swings in yearly return during the period 1979-84 show the new volatility of bonds. As calculated by Salomon Brothers, the return includes interest income and changes in bond prices; in the case of Treasury bonds and high-grade corporates, the interest is assumed to be reinvested.

INVESTMENT STRATEGY AND VEHICLES

have a large menu to choose from. While each type of bond carries its own combination of risks and rewards and serves different investment objectives, all have certain features in common (see box).

Decisions about which bonds to invest in depend in part on the degree of risk you're willing to assume in exchange for the highest available returns. Entries on the bond menu that are least likely to upset your stomach are **U.S. Treasury notes and bonds** and savings bonds, which are backed by the full faith and credit of the federal government. They're as immune to the risk of default as a security can be and are not callable (except for 30-year Treasuries, which are callable only after 25 years). The interest they pay is exempt from state and local income taxes. As the price of these advantages, Treasuries generally yield 0.75 to 1.5 percentage points less than high-grade corporate bonds.

Treasuries are accessible to the smaller investor. You need a minimum of $5,000 to invest in Treasury notes maturing in less than four years, but only $1,000 to buy bonds with longer maturities. If you don't want to pay broker or dealer commissions, you can buy Treasuries free of commission directly from any of the 12 Federal Reserve Banks or one of their 25 branches.

U.S. savings bonds are as safe as Treasuries and come in smaller denominations. Savings bonds fell out of favor during the 1970s, when inflation made their returns minuscule compared with alternative investments, but they've regained some glimmer since the Treasury Department revamped them in 1982. The new variable-rate Series EE bonds, in denominations of $50 to $10,000 with a ten-year maturity, do not pay out interest. Instead, they sell for half their face value and the interest is automatically reinvested, increasing the redemption value. If you hold the bonds for at least five years, they will return a guaranteed minimum of 7.5% or 85% of the average yield of five-year Treasury notes during the life of the bond, whichever is higher. That would now come to about 8.5%. But if you redeem the bonds sooner, the interest rate is substantially lower. If you sell them in one year, for instance, you will have earned a meager 5.5%. The accrued interest is not taxed until you cash in. Savings bonds can be bought without commission charge from banks and thrift institutions.

If you don't mind assuming slightly greater risk of price fluctuation for potentially higher returns, you can buy **zero-coupon Treasury bonds**. These are one of several varieties of zero-coupon bonds, which have become popular since they were first offered four years ago. Zeros function as automatic compounding machines. They pay out no interest and are sold at a fraction of what their face value will be at maturity. Accordingly, they allow you to lock into a future return that is wholly predictable, which makes them a good vehicle for investors who want to finance, say, their children's college education. Wholly predictable, that is, assuming the issuer doesn't default. In that case, since the entire proceeds of a zero are tied up until maturity, you may have nothing at all to show for your investment. "When you buy zeros, you're putting all your eggs in one basket, so you don't want the basket to have any holes in it," says Peter Hoey, a senior vice president of Financial Security Assurance, a firm that insures corporate debt. Unlike corporate or municipal zeros, Treasury zeros cushion you from that risk.

But Treasury zeros do share some drawbacks with other zero-coupon bonds. Their prices are far more volatile than those of ordinary bonds because so much of a zero's value derives from interest compounded over time. When interest rates drop, the zero's guarantee of continued reinvestment at a higher rate makes it more valuable than other bonds, so the market price rises more

A PRIMER: THE AAAs AND BBBs OF BONDS

Unlike a share of stock, which makes the investor part owner of an enterprise, a bond is a loan contract between the issuer (the borrower) and the bondholder (the lender). The contract provides for payment of interest, usually in semiannual installments, at a fixed rate (called the coupon rate) on specified dates. Moreover, the issuer is obliged to return the principal (the face amount of the bond) at maturity. The life of a bond can be as brief as one year or as long as 40 years. Bonds that mature in ten years or less are often called notes. Most bonds are negotiable: before they come due, you can sell them in a secondary market—on an exchange or over the counter.

The measures of bond performance are yield and return. Yield is simply the fixed annual interest payment divided by the bond's price—its market value—at the time. Return takes into account not only interest income but also any gain or loss in the market value of the bond. A bond's price and its yield always move in opposite directions. The coupon rate is fixed. Interest rates in the market fluctuate, however, so the prices of old bonds have to adjust to make their yields competitive with those of newer issues. Accordingly, when interest rates rise, the market value of the bond declines. Conversely, when rates fall, the bond is worth more.

Although you can expect to get the face value back if you hold a bond until maturity, bonds do carry certain risks. One is the "credit risk" that the issuer will default—fail to pay the interest or principal. The other is the "market risk" that a rise in interest rates will clobber bond prices and inflict capital losses.

Longer-term bonds are much more sensitive than shorter-term bonds to fluctuations in interest rates. That's because a bondholder, locked into a fixed rate, misses the opportunity to do better elsewhere if rates rise. The longer the bond's maturity, the greater the potential loss and the resulting decline in the value of the bond. This is why coupon rates on longer-term bonds are normally higher than on shorter-term bonds.

Another drawback common to most bonds is that they are "callable": you can be required to sell them back to the issuer before maturity. That can be painful if you are holding bonds with coupon rates well above prevailing rates for new bonds. Issuers call bonds either to reduce debt or to refinance some of it at lower rates. To give themselves that leeway, issuers often include a call provision in bond contracts. The call price—the amount the issuer is required to pay—is generally set either at face value or at a premium above it. Be wary of buying a callable bond at a substantial premium above the call price.

You can buy bonds through most brokers and bond dealers. They won't charge you for buying a newly issued bond, but they collect a handling fee for buying a bond issued earlier or for selling one before maturity. The fee can be charged explicitly as a commission or built into the price. Fees are set at the discretion of brokers and dealers. They range from about $2.50 to $30 a bond, depending in part on how many bonds you buy and whether you're a regular customer.

steeply. When interest rates rise, however, zero prices fall more steeply than prices of other bonds. If you don't hold zeros until maturity and you guess wrong on interest rates, you may take a bath. The other drawback is that you have to pay taxes each year on the accrued interest even though you don't have it yet. This provision makes zeros most suitable for Keoghs, IRAs, and other tax-deferred savings plans.

Bonds issued by corporations are riskier than U.S. government bonds, but the yields are higher. While **corporate bonds** don't hold out as much chance as stocks for long-term capital appreciation, they generally offer higher current income as well as greater security. In bankruptcy or liquidation, the bondholder has a claim on the company's assets ahead of any stockholder.

Corporate bonds vary in quality, of course. Standard & Poor's and Moody's Investors Service rate bonds by assigning them grades that go from AAA (Moody's equivalent is Aaa) to AA, A, BBB, BB, and so on down to D, the worst. While few corporations have ever defaulted on principal, some have been forced to delay interest payments. For example, Global Marine, a large offshore drilling company in Houston, suspended interest payments last summer on four bond issues rated B−. You can protect yourself against this risk by sticking with high-grade corporate bonds.

To lessen the risk from rising interest rates, you can buy either **floating-rate bonds** or **put bonds**. Interest payments on floating-rate bonds are regularly adjusted to prevailing interest rate levels. Put bonds can be sold back to the issuer at face value at specified times before maturity. Because floating-rate and put bonds are hybrid securities that share some of the advantages of short-term securities, their yields tend to be below those of fixed-rate bonds.

Another kind of hybrid is **convertible bonds**, which offer the high interest income of bonds along with some of the capital gains potential of stocks. Convertible bonds can be exchanged for a preset number of shares of the issuing company's stock at any time during the life of the bond. The value of those shares—the conversion value—is less than the face value of the bond at the time it is issued. If the price of the stock rises enough, the conversion value of the bond can exceed the face value. Ideally you'd want a convertible with a modest gap between price and conversion value as well as a high fixed-income yield relative to the yield you'd get if you owned the stock outright. Despite their merits, convertibles are often overlooked. Explains a top fixed-income analyst: "Many brokers aren't too familiar with convertibles, and they can generally earn higher commissions selling the underlying stock."

If you're venturesome in quest of plump yields and hefty capital gains, you can invest in **low-grade corporate bonds**, known euphemistically as high-yielding bonds—and uneuphemistically as junk bonds. Any bond rated BB+ or lower by S&P belongs in this category. Because the risk of default is greater, low-grade corporate bonds sell at substantially higher yields than high-grade bonds. Over the past ten years defaults per year have averaged 1.52% of the total dollar amount of low-grade bonds outstanding, compared with a 0.08% default rate for all corporate bonds.

If you're venturesome you can invest in bonds euphemistically known as high-yielding—and uneuphemistically as junk bonds.

"Low-grade bonds are not for the novice," says Richard Wilson, a Merrill Lynch vice president. But their defenders claim that the yields more than compensate for the greater risk of default. This view gets support from a recent study by Marshall Blume and Donald Keim at the University of Pennsylvania's Wharton School. Between January 1980 and June 1984, Blume and Keim report, low-grade bonds generated an average annual return—including losses from default—of 13.4%, vs. 7.1% for AAA bonds. Lately the average yield spread between high-grade bonds and low-grade bonds has been about three percentage points, which some analysts consider attractive. Martin Fridson, vice president and manager of credit research at Morgan Stanley, advises wariness toward low-grade bonds if the yield spread falls below 1.5 points.

The 30% tax bracket is the point at which you should start considering **municipal bonds** for maximum after-tax interest income. These securities are issued by state and local governments or governmental entities, and the interest they pay is exempt from federal income tax. If you buy municipals issued in the state where you pay taxes, the interest will probably be exempt from state and local taxes as well. Municipal bonds usually sell in $5,000 units. They come in two varieties: **general obligation bonds**, which are backed by the financial power of the issuer, including its ability to levy taxes, and **revenue bonds**, which are backed only by the income expected from the project they are designed to finance—a sewer system, say. Defaults on municipals over the years have amounted to less than 1% of the face value of all municipal bonds.

If even that default rate worries you, you can buy **insured municipal bonds**. You don't pay for the insurance directly. Instead, the issuer pays the premium and recaptures the cost by offering the investor an interest rate that is usually one-tenth to one-third of a percentage point lower than it would be on an uninsured bond. Insured bonds, which might otherwise rate as low as BBB, get AAA ratings from S&P.

Because they're tax exempt, municipal bonds yield less than taxable bonds, of course. In the late 1970s municipals yielded between one-fourth and one-third less than U.S. Treasury bonds and lagged even further behind high-grade corporates. Lately, though, municipals have yielded about 85% as much as taxable U.S. Treasury bonds of the same maturity. With 20-year municipals now yielding about 9%, an investor in the 50% tax bracket would have to get 18% from a taxable bond to wind up with the same after-tax yield. ■

INVESTMENT STRATEGY AND VEHICLES

A SHORT GUIDE TO BOND FUNDS

Buying a portfolio of bonds is expensive. Bond mutual funds give you diversity for less money, and the different types have different uses.

FOR an outlay of $1,000—sometimes for as little as $100—you can buy shares in a bond mutual fund and get the kind of diversification that takes substantial amounts of cash if you purchase bonds directly. Bond funds, which invest in bonds of numerous issuers and various maturities, have grown robustly in the past ten years. According to A. Michael Lipper, president of Lipper Analytical Services, a well-known tracker of mutual funds, the field has expanded from 79 funds with assets of $7 billion in 1976 to about 400 funds holding more than $80 billion.

A BEVY OF BOND FUNDS

TYPE OF FUND	ANNUAL RETURN 1980-85
Convertible	18.2%
High current yield	13.2%
High-grade corporate	12.4%
U.S. government	11.2%
GNMA	10.8%
Municipal	8.5%

SOURCE: LIPPER ANALYTICAL SERVICES

Convertible funds include convertible preferred stock as well as convertible bonds. GNMA funds are those that invest in securities issued by the Government National Mortgage Association (Ginnie Mae).

Bond funds offer advantages besides low-cost diversification. Fund managers relieve you of the need to monitor individual bond issues for credit and interest rate risks. Moreover, the fund will automatically reinvest your interest payments if you wish.

An investor has several kinds of bond funds to choose from. They include **U.S. government funds**, which hold bonds issued by the Treasury and various government agencies; **GNMA funds**, which hold mostly Government National Mortgage Association securities (Ginnie Maes); **high-grade corporate funds**, in bonds rated A or higher by Standard & Poor's or Moody's Investors Service; **high current yield funds**, primarily in corporate bonds rated BBB or lower; and **municipal bond funds**, which invest in tax-exempt bonds. Investors who want both belt and suspenders, and don't mind giving up about a third of a percentage point of yield, can turn to **insured municipal bond funds**. But that's probably more safety than you need. Says Richard Franke, president of John Nuveen & Co., a Chicago investment bank that specializes in municipals: "They're a terrific marketing idea, but if the portfolio manager is doing what he's supposed to do, you shouldn't need insurance."

The best source of information on the long-term performance of bond funds is the annual directory sold by Wiesenberger Investment Cos. Service of New York. It costs $295 but is available at some public libraries. Bond fund performance hinges on the fund manager's reading of interest rate trends and his investment strategy. At the end of June the average U.S. government fund had 28% of its assets in bonds with 21- to 30-year maturities, which tend to be higher yielding but more volatile than bonds with shorter maturities. But that average conceals considerable diversity. Federated Income Trust in Pittsburgh had 89% of its assets in 21- to 30-year bonds; John Hancock's U.S. Government Securities Fund was entirely invested in maturities of ten years or less. Says David Turner, John Hancock's portfolio manager: "The chief objective of the fund is security of principal, so we don't want too much volatility."

Like other mutual funds, bond funds are either load or no-load. Both kinds impose a built-in annual management fee—usually 0.4% to 1.5% of average assets. Load funds, sold by brokers as well as the fund sponsors, also charge a sales commission of 1% to 8.5% up front. No-load funds, which are usually sold directly by the sponsor, don't charge up-front commissions, but many make up for it at least in part by imposing other charges. "There can be a lot of hidden fees in no-load funds," says Lipper. Some charge a redemption or exit fee that may run as high as 6% in the first year. Others take out as much as 1.25% of the fund's average assets each year. Named for the Securities and Exchange Commission rule that allows them, these 12b-1 funds seldom spell out their actual fees in their prospectuses.

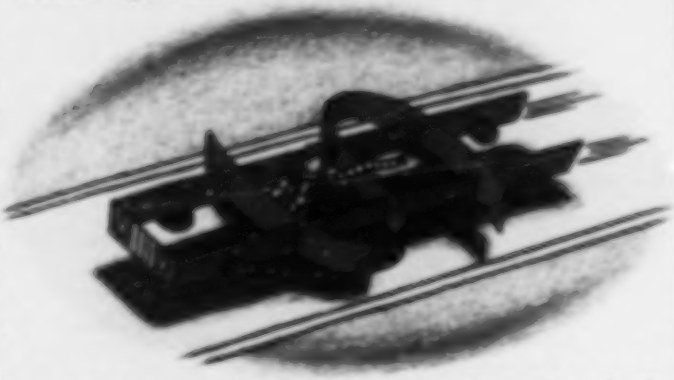
ACCORDING TO LIPPER, the following bond funds paid the best returns over the past five years: U.S. government funds, **Fidelity Government Securities Fund**, Boston; GNMA, **Vanguard Fixed-Income Securities Fund—GNMA Portfolio**, Valley Forge, Pennsylvania; high-grade corporate, **Putnam Income Fund**, Boston; high current yield, **Kemper High Yield Fund**, Chicago; municipal, **MFS Managed Municipal Bond Trust**, Boston.

If you want a steady stream of income and intend to hold your shares for a period of years, you can invest in bond unit trusts. Unlike mutual funds, unit trusts are not actively managed. Trust sponsors buy mostly long-term bonds and hold them until maturity unless they foresee a default. Even when they cash in their bonds, they don't add new ones. Accordingly, unit trusts are not generally affected by fluctuations in interest rates. Unit trusts are sold through brokers or directly by the sponsors. Most trusts require a minimum investment of $1,000 and carry a 4% to 5% sales charge up front. **—Edward Boyer**

INVESTMENT STRATEGY AND VEHICLES

OPTIONS AND OTHER EXOTICA

Specialized investment products now let you play a host of new games—among them placing a leveraged bet on the whole stock market.



ONCE upon a time brokers had just three things to do: sell stocks, sell bonds, and send Christmas cards. Nowadays they also peddle a plethora of new investment vehicles devised to help their customers cope with the inflation and volatile financial markets of the past dozen years. The new products give the amateur player access to markets and strategies that were once the private domain of big institutions. Some of the new vehicles are decidedly not for everyone; they demand a pro's expertise and entail risks that could quickly send your nest egg the way of Humpty Dumpty. Here are some new and nontraditional investment vehicles that seem free of unusual hazards and offer the individual potentially attractive winnings:

▶ **STOCK-INDEX OPTIONS.** Suppose you have neither the time to try besting the market by following individual companies and buying their shares, nor the money to buy the safety that a large and diversified portfolio affords. Yet you are impatient to increase your wealth with a leveraged investment. The answer may be the hottest of the new vehicles: options on a whole basket of stocks in an industry—a group of computer manufacturers or oil companies, for example—or the entire stock market. Broad stock-index options let investors bet on moves in Standard & Poor's 500-stock index, the Dow Jones industrials, or even the volatile index of Nasdaq over-the-counter stocks.

Options to buy or sell individual stocks have been available since 1973. An option gives its owner the right, but not the obligation, to buy or sell securities for a specified price before a specified future date.

RESEARCH ASSOCIATE *Brett Duval Fromson*

Options also provide plenty of bang for the buck. If, for example, an investor is bullish on the short-term prospects for IBM, it would cost more than $12,500, based on a recent price of $125, to buy 100 shares of Big Blue. Even buying the stock on margin would require an outlay of at least $6,250 before commissions. But you can buy a "January 130" call option on IBM, recently trading at only $281. The option gives you the right to buy 100 shares of IBM at $130 anytime through January 19, when the option expires. No matter how high IBM stock goes, the option holder is guaranteed a price of $130, and therein lies the potential for profit. Conversely, if you think IBM stock is poised to decline, you could buy a January 120 put option, which gives you the right to sell 100 shares of IBM stock at $120. If the stock price drops below $120 a share, you pocket the difference.

Stock-index options work in much the same way, with one exception. It's impractical for an option holder to exercise his right to buy or sell a whole basket of securities, and few players are interested in ownership anyway. So any profit or loss is settled in cash. As with individual stock options, there's a limit to losses: if you bet wrong, you're out the price of the option and no more. That's not true of stock-index *futures*, which the inexperienced should avoid like a bramble patch. You can make a bigger killing with a futures contract than with stock-index options if the market goes your way. If it doesn't, you can lose many times your stake.

The most popular stock-index option is the S&P 100, based on an index composed of 100 blue-chip stocks—among them such household names as AT&T, Exxon, General Electric, and IBM. An investor can buy, say, a two-month call on a portfolio recently worth $18,000 for only $300. If the market rises, he reaps almost the same profit as another investor who committed many times as much to owning the whole portfolio. Though the S&P 100 index represents a limited group of stocks, it's a convenient way to bet on the moves of the overall stock market, since it closely follows each jiggle of the S&P 500 index.

Many investors use the new index options not to place bets but to lay off some of the risks of owning stocks. This practice, known as hedging, can cut your losses if the stock market declines. For example, an investor who owns a diversified portfolio of stocks can buy an S&P 100 put option whose value would soar as that of the portfolio sank. Yet if the stock market rallied sharply, the investor would lose only the price of the put while rejoicing in the portfolio's ascent.

As a rule, a nonprofessional investor should be only a buyer, and not a seller, of options. Selling, or "writing," them can be perilous. A relatively safe exception is to sell so-called covered calls on securities you hold. If, for example, you own IBM and expect the price to remain fairly steady in coming months, you can sell a six-month call option. If IBM doesn't go up during that period, you'll be richer by the amount you got for the option. If it takes off, however, you'll miss the party because the gains will belong to the option holder. In effect, you will have traded potential future gains for cash now.

▶ **INTEREST RATE OPTIONS.** For investors interested in the bond market but disinclined to own big portfolios, there's a leveraged way to bet on where interest rates are headed. Options representing $100,000 worth of securities are available on U.S. Treasury bonds and Treasury notes. Like stock-index options, interest rate options can be used not only to speculate but also to hedge a portfolio—in this case against an adverse move in rates. Few individuals hold enough bonds to take advantage of hedging, but they can buy into bond mutual funds that do.

More than a dozen bond funds, with assets totaling more than $20 billion, have begun using interest rate options as a way to raise current income. The fund managers

INVESTMENT STRATEGY AND VEHICLES

do this by selling call options against their portfolios. In the past year, as bond prices generally rose, they have therefore missed out on some capital gains. But when bond prices lag, this ploy can put a fund out ahead.

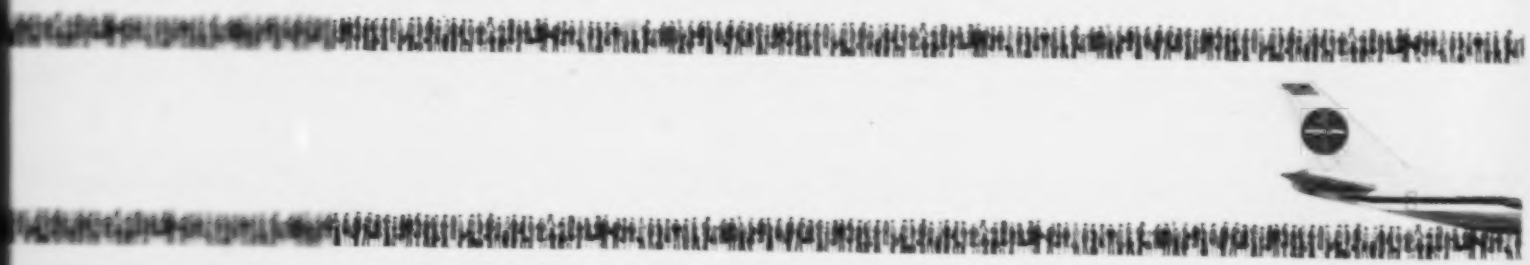
▶ **ECU BONDS.** You're convinced the dollar is headed downward and you hanker to speculate in foreign currencies. Options are available only on individual currencies, however, and you don't want to buy a lot of different ones. A simpler approach is to buy ECU bonds, which first appeared in the U.S. market a year ago. The bonds are denominated in European Currency Units, a basket of ten currencies in which each currency is weighted by the size of the country's economy and its relative share of the ten countries' trade. The West German deutsche mark has the most heft, the Luxembourg franc the least. The European Economic Community floated the first ECU bond issue in the U.S., and four more have followed—one from Hercules, an American chemical producer.

The interest rates on ECU-denominated bonds are generally lower than on dollar bonds. The European Economic Community's bond, for example, yields about 1½ percentage points less than U.S. Treasury bonds of the same maturity. That's a lot of yield to give up just to get foreign currency exposure, but so far it's been a price worth paying. The drop in the dollar through September has helped send the EEC bond 32.3% higher so far in 1985.

▶ **AMERICAN DEPOSITARY RECEIPTS (ADRs).** Investor interest in foreign stocks has never been higher, but only 100 or so, mostly Canadian, are listed on American exchanges. Buying stocks listed on foreign exchanges can be expensive; unless your broker has a seat on one of them, which few U.S. brokers do, he will have to buy through an overseas firm and the commissions may be steep. Owners of overseas stocks also face the complications of foreign tax laws and the nuisance of converting dividend payments into dollars. It may also be difficult to keep track of your stocks' performance, since American newspapers carry only a limited number of quotes from foreign bourses.

There is a simpler way. A growing number of investors are buying American Depositary Receipts of non-U.S. companies. ADRs are receipts for foreign shares held in trust by a bank—usually a foreign branch or a local correspondent of an American bank—and they are increasing rapidly. Dean Egly, who runs the ADR operation at Morgan Guaranty Trust, says the number of ADRs trading in the U.S. has more than doubled since 1980, to 1.5 billion. Some of the receipts are for more than one share of stock. Each ADR of Honda Motor, whose stock doesn't trade in the U.S., represents ownership of ten shares of Honda stock, which is traded on the Tokyo exchange. Commissions on ADRs are the same as on regular stock purchases, and a growing number of ADRs are quoted in newspapers daily. Moreover, for a small fee five New York banks handle all the paperwork and remit dividends converted into U.S. dollars.

▶ **DUAL-PURPOSE INVESTMENTS.** Stocks offer both dividend income and capital gains. But with Americus trusts, you can



UNITED
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take your pick and get more of what you want. Americus Trust Shareowner Service Corp., a New York firm that sponsors the trusts, has split some Exxon stock and some old, predivestiture AT&T shares into a Prime part and a Score part. The Prime part entitles its holders to all dividend income from the stock and a small participation in any future price appreciation. The Score part, akin to a long-term warrant on the stock, entitles its holder to all price appreciation beyond the small amount allocated to the Prime holder. Prime and Score trade separately.

Investors who want to buy into a bigger portfolio of split stocks can buy shares in two closed-end mutual funds recently offered by Merrill Lynch. Investors in both funds, Gemini II and ML Convertible Securities, can buy either income or capital-appreciation shares.

Joseph Debe, Americus's president, says his firm is going to split the stocks of 29 more big-name companies, including General Electric and IBM. Registration statements to create the trusts are now on file with the Securities and Exchange Commission. Investors who already own these stocks may want to consider swapping them for their Prime and Score components. Those who want more dividend income can then sell off the Score part and plow the proceeds into more Prime components. Investors more interested in capital gains can do the opposite.

▶ **MASTER LIMITED PARTNERSHIPS.** You like the high yields and tax breaks offered by limited partnerships, such as those widely sold in oil and real estate ventures. But there's no secondary market where you can quickly convert your interest to cash, and you don't want to tie your money up for years. The growing list of "master" limited partnerships, mostly in oil drilling and income funds, are designed to solve your problem. They first appeared in 1981, when Apache Petroleum, an oil exploration company, allowed investors in its many limited partnerships to consolidate their interests into one grand, or master, partnership. The units are listed on the New York Stock Exchange, and you can buy and sell them through your broker. Twenty-two more master partnerships have since appeared and more are being formed every day, as oil companies spin off some of their properties. Says Fuhrman Nettles, a vice president at Robert A. Stanger & Co., a New Jersey-based research firm specializing in tax shelters: "The movement toward master limited partnerships is growing like gangbusters."

Investors who buy the units get a direct interest in a diversified group of oil properties and income payments that can in some cases be munificent. The Damson Energy Co. master partnership B, traded on the American Stock Exchange, has been one of the biggest gushers, with a recent yield of 18%. What's more, the yield is regarded by the IRS as a return on capital, not as ordinary income, and it's taxed at low capital gains rates when the units are sold. Damson B's high yield results from the fact that it is paying out 100% of its income after expenses. Others pay less: the Belden & Blake Energy Co. master partnership yields only 16%, but it's plowing about 25% of its income back into exploration. Investors may get lower yields from this arrangement, but they have the prospect of much bigger gains down the road should the drillers find oil.— **John J. Curran**

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INVESTMENT STRATEGY AND VEHICLES

WHERE TO PARK YOUR CASH

Yields, access, minimum investment, taxes—the fine print is the key to sorting out short-term instruments like CDs and money funds.

EVERY now and then you may find yourself with some cash that you'd like to park for a while. Perhaps you've sold some stocks and haven't yet decided how to invest the money for the longer run. Four kinds of short-term fixed-income instruments make good parking places: money market mutual funds, money market deposit accounts, short-term certificates of deposit, and Treasury bills. All pay much better yields than a passbook savings account and still offer protection against serious capital losses.

These instruments for parking cash differ in degree of liquidity (ready access to your money). The most liquid are the money market deposit accounts—MMDAs for short—offered by banks and thrift institutions. MMDA holders can make any number of withdrawals from their accounts but are not allowed to write more than three checks a month to third parties. According to a breakout of investor data done for FORTUNE by Market Facts Inc., a financial market research firm in Chicago, MMDAs account for 12.2% of all liquid assets and 4.9% of total financial assets held by U.S. households—impressive figures, considering that the accounts have only been around since December 1982. They're safe: the federal government insures both principal and interest, up to $100,000 per person at one institution. "No one has ever lost a penny on a federally insured account in MMDAs," says Robert K. Heady, publisher of *Bank Rate Monitor*, based in North Palm Beach, Florida. The *Monitor* and another Heady publication, *100 Highest Yields*, are weekly newsletters that track developments in the MMDA and short-term CD markets.

RESEARCH ASSOCIATE *Patricia Sellers*

MMDAs aren't all alike. For one thing, institutions that offer them differ in minimum-deposit requirements. Most penalize you if you let your balance fall below the minimum—usually $1,000. Moreover, yields vary from city to city and even from one institution to another within the same city. Institutions differ not only in the rates they pay but also in the way they compound and credit interest. According to Robert Heady, the institutions that offered the highest yields on MMDAs in the first half of 1985 were **First Federal Savings Bank** in New Orleans, **Meridian Savings Association** in Arlington, Texas, and **Western Savings Association** in Houston. To open an account in an out-of-town bank or thrift, all you have to do is call the institution's officer in charge of national consumer money market accounts.

Money market mutual funds, also highly liquid, became popular in the early 1970s as rising interest rates began to make traditional passbook savings accounts look unattractive. Most brokers and mutual fund organizations offer a fund of this kind and will transfer money to it from equity or bond funds at no charge. Money market funds now account for 4.6% of liquid assets and 1.9% of total financial assets held by U.S. households.

The funds come in several varieties. The most popular is the general purpose money fund, which invests in a wide range of short-term securities such as T-bills, certificates of deposit, and commercial paper (short-term corporate IOUs). Other funds invest in a single type of instrument, such as U.S. government securities or tax-exempt bonds of state and local governments. Money funds are not federally insured, but their safety record is impressive. In 1983 the money market fund industry lost 25% of its deposits as many investors moved their cash into the more lucrative stock market, yet the funds were able to process redemptions quickly and avert serious trouble.

Most funds call for only a modest minimum investment, often as little as $1,000, and some set no minimum at all. You can write as many checks as you wish against the account. Generally the checks must be in amounts of $500 or more. Money funds are no-load, meaning that the only standard cost is a built-in annual fee—ranging from a quarter of a percent to 2% of the fund's assets—that the sponsor deducts to cover management service and operating costs.

Yields vary from fund to fund. Since the interest that a fund earns on its securities changes only as they mature and are replaced by other securities, money fund yields tend to lag behind fluctuations in interest rates. The extent of the lag—typically four to six weeks—depends on the portfolio's average maturity. In general, funds with a short average maturity do better when interest rates are rising because they can take advantage of the rise quickly; those with a long average maturity do better when rates are falling because their return remains high longer.

LARGER FUNDS generally pay higher yields than smaller funds. The larger the fund, the less risk it runs to the portfolio by mixing some higher-yielding securities that have longer maturities with safer, lower-yielding securities that mature sooner. According to William E. Donoghue, president of the Donoghue Organization in Holliston, Massachusetts, and publisher of the authoritative *Donoghue's Money Fund Report*, the general purpose money funds that paid the best returns over the past three years were **Kemper Money Market Fund**, Chicago; **Prudential-Bache Money Mart Assets**, New York City; **E.F. Hutton Cash Reserve Management**, New York City; **Vanguard Money Market Trust—Prime Portfolio**, Valley Forge, Pennsylvania; and **T. Rowe Price Prime Reserve Fund**, Baltimore.

Investors who want greater safety at slightly lower yields can opt for a fund that holds only U.S. government securities. As a rule, funds that invest solely in Treasury bills yield about one-quarter of a percentage point less than general purpose money funds, but some funds do better than those that invest only in T-bills by buying the securities of

such federal agencies as the Federal Home Loan Bank Board. The U.S. government money funds that have performed best over the past three years are **Cardinal Government Securities Trust**, Columbus, Ohio; **Vanguard Money Market Trust—Federal Portfolio**, Valley Forge; **Calvert Group First Variable Rate Fund**, Washington; **Merrill Lynch Government Fund**, Boston; and **Shearson Government and Agencies**, New York City.

Like the interest on MMDAs, dividends on money fund shares are generally taxed as ordinary income by federal and state authorities. Accordingly, investors in high tax brackets are often better off putting their cash in a tax-exempt money fund. On an annual basis, the average yield of tax-exempt money funds in the first half of 1985 was 5.2%, which for an investor in the 50% tax bracket would have been equivalent to 10.4% from a taxable fund. That compared favorably with the average yield of 8% on general purpose funds and 7.7% on U.S. government funds. The best performers among tax-exempt funds over the past three years: **Lexington Tax Free Money Fund**, Saddle Brook, New Jersey; **Calvert Tax-Free Reserves—Money Market Portfolio**, Washington; **Vanguard Municipal Bond Fund—Money Market Portfolio**, Valley Forge; **T. Rowe Price Tax-Exempt Money Fund**, Baltimore; and **E.F. Hutton Municipal Cash Reserve Management**, New York City.

Most tax-exempt funds are exempt only from federal income taxes, not from state and local taxes. If you live in a high-tax state such as California, Massachusetts, or New York, you should consider the specialized money funds that invest in tax-exempt securities issued by a particular state or by government authorities within that state. The dividends of such funds are exempt from federal, state, and local income taxes.

IF YOU'RE WILLING to forgo some liquidity, you can generally get a better pretax return than money funds offer by acting as your own fund manager, buying short-term CDs or T-bills and holding them until they mature. CDs, the nation's most popular short-term investment, account for 24% of the liquid assets and 9.6% of total financial assets held by U.S. households. Short-term CDs come in standard maturities of three, six, nine, and 12 months. As with MMDAs, the federal government insures CDs, both principal and interest, up to $100,000 per person. Normally banks and thrifts charge no commissions or fees when you buy or cash in a CD at maturity—but they levy a substantial penalty if you withdraw your money before maturity. Legally the minimum early withdrawal penalty on a CD that matures in one year or less is 30 days' interest. But some institutions charge more. Chemical Bank in New York City, for example, charges three months' interest for early withdrawal of a six-month CD and six months' interest on a one-year CD. Since CD advertisements do not spell out early withdrawal penalties, you have to ask your account officer.

To avoid those penalties, you may want to buy your CD from a major brokerage firm like Merrill Lynch. Since the large brokers scour the country for high-yielding CDs and create a secondary market in them, they sometimes offer better returns than banks or thrifts and also let you cash in your CD before maturity without penalty. Deposit-insurance authorities in Washington are trying to do away with federal insurance on these so-called brokered deposits, but they seem unlikely to succeed. So at least for the time being, most brokered CDs are just as safe as bank and thrift CDs.

Yield information is often hard to decipher. For example, ads for CDs that mature in less than one year quote an annual yield that assumes the investor will reinvest his principal and interest. This is misleading, not only because the investor may not want to roll over his CD, but also because yields are based on current rates and the institution is unlikely to offer the same rate at rollover as it did on the original CD. So be sure to ask how much your account will earn through maturity. Also find out whether the institution allows "add-ons." Some banks and thrifts will let you put more money into your CD weeks or even months after you purchased it, at the same rate of interest as the original amount. The interest CDs earn is taxable as ordinary income. Early withdrawal penalties, however, are tax deductible.

Investors who are especially concerned about safety can always turn to Treasury bills, available at a nominal fee from banks, some thrifts, and brokers, or less conveniently but free of sales commission from the 12 regional Federal Reserve Banks or one of their 25 branches. T-bills come in maturities of three, six, and 12 months; they're available in a minimum denomination of $10,000 and in multiples of $5,000 above that. Unlike other short-term vehicles, which pay periodic interest, T-bills are sold at a discount from face value and redeemed at full face value when they mature. The interest the T-bill holder gets is the difference between the purchase and redemption prices. Interest earned on T-bills is subject to federal income tax but exempt from state and local taxes.

—Edward Boyer

PARKING PLACES

	YIELD RANGE 9/84 – 9/85 HIGH	LOW
SHORT-TERM INVESTMENTS		
General purpose money market funds	11.08%	7.25%
U.S. government money funds	10.57%	7.09%
Tax-exempt money funds	6.22%	4.31%
Money market deposit accounts	9.78%	6.70%
Six-month certificates of deposit	11.15%	7.45%
One-year certificates of deposit	11.50%	7.89%
Three-month Treasury bills	10.57%	7.09%
Six-month Treasury bills	10.99%	7.26%
One-year Treasury bills	11.39%	7.66%

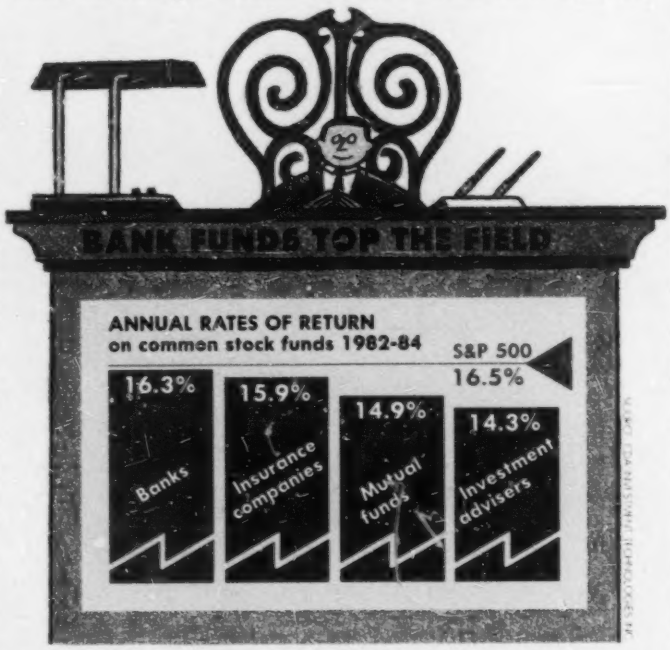
SOURCES: DONOGHUE'S MONEY FUND REPORT, BANK RATE MONITOR, SALOMON BROTHERS

While yields on all these instruments rise and fall with the tides of interest rates, some pay more than others. U.S. Treasury bills require a minimum investment of $10,000, much more than money funds or CDs. As a rule, the longer the maturity of a T-bill or CD, the higher the yield. The wide range between highs and lows reflects the general ebbing of interest rates within the past year.

SOURCES OF HELP

BANKS SHINE AT MANAGING MONEY

Believe it or not, performance-minded investment managers in today's trust departments sometimes put sizzle in the customers' stakes.



Surprise. Measured by return on equity investments, bank trust departments outperformed mutual funds, insurance company funds, and investment advisers from 1982 through 1984, according to a recent study.

WHAT is the fastest way to make a small fortune? In years past many people knew the punch line: "Give a large fortune to a bank trust department." As the joke suggests, some banks did far worse than simply fail to keep pace with the performance of other money managers. They actually lost money for their clients. A 1976 study showed that over the previous five years, four out of 20 major banks achieved negative rates of return on their common stock funds. Disgruntled trust customers often complained and sometimes sued. Horror stories abounded, like the one about a big Texas bank that managed to lose 40% of the assets of a small trust.

Stung by bad publicity and the loss of trust customers to investment advisers and other money managers, banks have reorganized their trust departments to improve investment performance. Some have set up their portfolio managers in separate investment advisory subsidiaries and given them a share of the profits. Banks must have done something right: those weakling bank funds of the 1970s are strong performers today.

A recent study found that bank commingled trust funds outperformed mutual funds, insurance company funds, and even investment advisers over the three years from 1982 through 1984 (see chart). "That bank funds would even be in the running would surprise many people," says Robert A. Levy, president of CDA Investment Technologies, the firm that did the study. It was commissioned by the American Bankers Association, but the findings should not be dismissed for that reason. CDA, based in Silver Spring, Maryland, is a reputable company, and the procedures followed in the study seem sound.

Although a fence of federal rules and regulations stands between banks and individual investors, there are several ways to get some of your money under bank management, if you have enough of it. The most direct route is simply to hire a bank, as you would any other investment adviser, to manage your money. But this route is only for investors with large sockfuls of cash—generally at least $500,000.

A few banks, however, now sell their own commingled trust funds for individual retirement accounts. They include Citibank of New York, Wells Fargo Bank in Los Angeles, and San Francisco's Bank of California. The mutual fund industry's trade association has sued, claiming among other things that sales of the funds violate a federal law against the issuance of securities by banks. A federal district court in Washington has ruled that banks can sell IRA funds, and a federal court in California has ruled that they cannot. The appeals go on.

At least three other banks have poked their noses under the mutual fund industry's tent. These banks serve as investment advisers to funds distributed by conventional mutual fund sponsors. Security Pacific National Bank of Los Angeles, for example, manages the Pacific Horizon Funds, affiliated with Dreyfus Corp. Chase Manhattan is investment manager of the Park Avenue Funds, also sponsored by Dreyfus. First Union National Bank of Charlotte, North Carolina, advises the Salem Funds, sponsored by a subsidiary of Keystone Massachusetts Group.

The only way to get into one of a bank's own common stock funds is to put the money into a trust at the bank. The simplest procedure is to set up a so-called living trust, which allows the individual to control the assets. The trust can be canceled at any time. It can be written to terminate on the person's death, or it can continue to oversee distribution of the assets to heirs, an arrangement that can avoid probate for assets in the trust.

Banks require a minimum investment of $100,000 to $500,000 for their funds, depending on the institution. A bank typically charges a 1% annual fee that covers managing the money and administering the trust. All banks require that the trust be bona fide—that is, have some purpose other than serving as a device to get money into the commingled trust funds. This is to keep the banks out of trouble with the Securities and Exchange Commission, which might otherwise contend that the bank was selling a mutual fund to the public. One acceptable purpose of a trust could simply be to pay bills or manage property for someone who travels a lot, or is going on a long trip. Some banks insist that a lawyer review and sign the trust document. This can add $50 to $750 or more to the price of admission.

A bank with a high-performance stock fund especially needs ways of politely turning off investors who want to get in. "The number of calls we receive from people wanting to deposit money is incredible," says William Jeffery III, president of California First Bank's investment counseling subsidiary. "But we wouldn't take a trust for investment purposes. We just have to turn all that money away." **—Dexter Hutchins**